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SUBJECT: Treasury U/S Adams Visits Istanbul Amid Market Turbulence

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11. (SBU) Summary: In a day in Istanbul June 13, Treasury Under Secretary Timothy Adams met with the Turkish Treasury Under

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Secretary, a Central Bank Vice-Governor and private sector analysts

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and bankers. Despite the sell-off in Turkish markets, neither the officials nor the bankers seemed alarmed, though the analysts sounded a cautionary note. The Turkish Treasury Under Secretary stressed Turkey's much-improved fundamentals and said Turkey had nearly completed the prior actions for the reviews under its IMF program. In a television interview, U/S Adams noted that Turkey had a strong economic team in place. End Summary.

Turkish Officials Concentrate on Fundamentals

12. (SBU) In his meeting with U/S Adams, Turkish Treasury Under Secretary Ibrahim Canakci expressed confidence about Turkey's

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ability to withstand market turbulence. Canakci admitted Turkey had been hit more than other countries, citing the slowdown in disinflation evident in the April and May inflation data. Canakci said he believed, however, that the uptick in inflation was temporary and that the authorities had put appropriate policies in place.

13. (SBU) Canakci praised the Central Bank's higher-than-expected rate hike. While Treasury departments normally don't like higher interest rates, he was happy to see the Central Bank showing its commitment to price stability. Treasury has suffered in the past from high real interest rates induced by high inflation and instability, and therefore welcomed the rate increase. Canakci even claimed the politicians understand that the increase was necessary.

14. (SBU) Canakci said fiscal policy has also been further tightened, with the IMF review adding a new performance criteria: an overall ceiling on primary expenditures expressed in nominal lira terms - a commitment by the Government to save any overperformance in revenues. Treasury's financing position has been boosted by receipts from privatizations and from asset sales by the State Deposit Insurance Fund (SDIF), neither of which are being used to

finance expenditures.

15. (SBU) Canakci said the Government has nearly completed the prior actions for the third and fourth reviews under the IMF program and Canakci expected a board meeting to take place in early July. One key structural reform, the law reducing Corporate Income Tax rates from 30% to 20% was passed by parliament on June 14, the day after U/S Adams met Canakci.

16. (SBU) On June 15, as expected, President Sezer referred the social security reform legislation to the Constitutional Court. Sezer had vetoed the legislation for political reasons, according to Canakci, based on his "different perception" of the role of the state. In the meeting, Canakci said that so long as the Court did not issue an injunction against the parametric changes to the pension system, the reform would achieve its aims.

17. (SBU) Canakci also mentioned upcoming World Bank board decisions that would help demonstrate that the authorities are continuing to move ahead on structural reforms. The first is the second tranche of the PFPSAL3 loan and the second is a new follow-on facility to continue and expand public sector reforms, known as the PPDPL. Both loans cover social security reform, other fiscal reforms and banking sector reforms such as state bank privatization.

18. (SBU) Canakci described the improvements in the structure of state debt in recent years. FX-linked or -denominated debt had totaled 58% of total debt at the end of 2002, but had been reduced to 38% at the end of 2005. Canakci said the recent fall in the exchange rate had brought this ratio back up to 40%. Floating rate debt had been reduced from 63% of lira-denominated debt to 50% as of June 2, 2006. Net debt to GDP was 55.8% at the end of 2005. For the broader economy, foreign exchange reserves nearly cover all short-term debt, and do cover short-term debt if banks' reserves are included.

19. (SBU) Growth was now expected to slow in 2006, although the Government predicted it would come in at 5.5% whereas market analysts average projection is 4.7%. The combination of slower growth and a weaker lira is expected to moderate the Current Account

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Deficit to around 6.5% to 6.7% (between \$26 and \$27 billion) versus the pre-sell-off forecast of 7%. Canakci said Foreign Direct Investment would total somewhere between \$13.5 billion and \$20 billion, with the lower end of this range already locked-in from previously-agreed transactions.

110. (SBU) Canakci cited the banking sector's increased capitalization, reaching a capital adequacy ratio of 24%. Even if adjusted for the Basel 2 criteria, he said the ratio was 16 or 17%, one of the highest in Europe. The non-performing loan ratio has declined from 20% to 5%.

111. (SBU) When U/S Adams asked him what worried him, Canakci cited the approaching elections and Turkey's continuing high unemployment rate despite job growth. Canakci asserted that the politicians understand that the solution is not to loosen fiscal policy but unemployment remains a sensitive issue.

112. (SBU) When U/S Adams asked how he could be helpful, Canakci asked for U.S. support in gaining access to European Bank for Reconstruction and Development Bank lending, by means of a board consensus. He also reiterated his request for U.S. support for Turkey's candidacy to host the 2009 Bank/Fund annual meetings.

113. (SBU) Later in the day, U/S Adams also met briefly with newly-appointed Central Bank Vice-Governor Mehmet Yorukoglu. Yorukoglu, having been on the job less than a week, did not have much to say about the Central Bank's view. Earlier, both Koc Bank CEO Kemal Kaya and Murat Ucer of Globalsource praised the appointment of Yorukoglu, since he is a respected academic from Sabanci University. Yorukoglu has extensive U.S. experience, having obtained his doctorate from the University of Rochester, followed by teaching stints at the University of Chicago and Wharton. In the meeting, Yorukoglu described Turkey's current problems as a supply

shock, meaning that the usual trade-off between growth and inflation were not relevant.

Bankers Calm

¶14. (SBU) In a series of private sector meetings, U/S Adams encountered no sense of alarm over the previous months' market sell-off, despite his visit coinciding with a particularly sharp fall in markets which led to a Central Bank intervention.

¶15. (SBU) CEO's of leading Turkish Banks (Is Bank, Koc-Yapi Kredi, TEB, and HSBC) expressed moderately favorable views of Government economic policies and the bank regulatory agency while criticizing the Government's handling of the Central Bank Governor appointment. Though the bankers admitted it was not yet clear how big a hit Turkish corporations had taken on the depreciation of the lira, they did not seem too concerned about it. They said it was not clear how well corporates had protected themselves through "natural hedges" (i.e. foreign exchange revenues to offset foreign exchange borrowings) and non-transparent off-balance sheet hedging. HSBC CEO Piraye Antika implied that corporates had to borrow in foreign exchange to some degree: "If they had borrowed 100% in lira, they would be bankrupt."

¶16. (SBU) On the recent outflows from Turkish markets, the bankers painted a more nuanced picture: as foreign portfolio investors pulled out of Turkish assets, local corporates and individuals took advantage of the lower exchange rate to buy lira. At the same time, there was a trend from bonds to deposits.

Analysts Worried

17.(SBU) Economic analysts Murat Ucer of Globalsource and Emin Ozturk of TEB seemed worried about the medium-term outlook. With global markets likely to be edgy, and the pillars of the Turkish "story" looking weaker, they expect more problems ahead. Ucer described the pillars as political stability, liquid global markets, and Turkey's macro situation (lumping in IMF, EU, and disinflation). Reduced global liquidity is coinciding with problems on the other pillars. Neither analyst had reservations about the Central Bank intervention in the foreign exchange market. Ozturk said the intervention was warranted in a small open economy dependent on capital inflows in an illiquid market, yet locked into inflation targeting.

TUSIAD Criticizes GOT

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¶18. (SBU) U/S Adams also met with TUSIAD Chairman Omer Sabanci, who reiterated privately his public dismay over the Government's lack of strategic vision on EU accession and its excessive focus on religious issues.

TV Interview

¶19. (SBU) In an interview with the leading financial news TV station CNBC, U/S Adams noted that Turkey had a strong economic team in place, a comment that was picked up in several Turkish newspapers the following day. Central Bank Vice-Governor Erdem Basci later told us that he appreciated U/S Adams' public comments.

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